# Freedom To Choose

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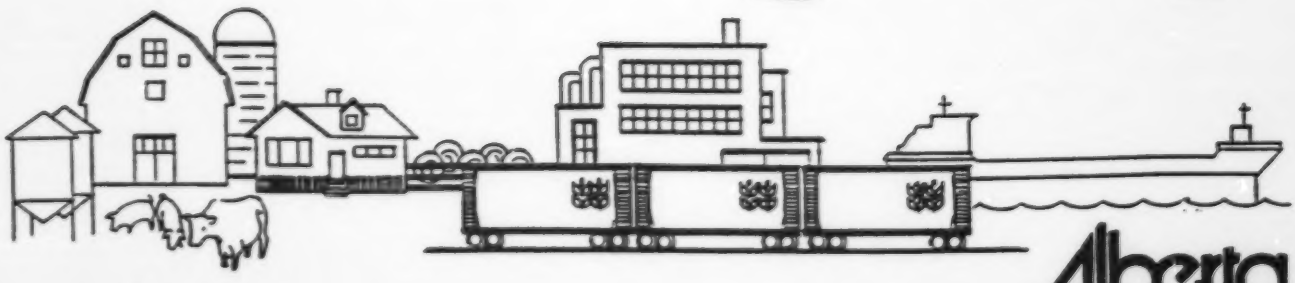
## Addendum



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Office of the Minister

131 XXX Legislature Building, Edmonton, Alberta, Canada T5K 2B6 403/427-2137

March 4, 1991

Dear Sir/Madam:

When I released Alberta's Freedom to Choose proposal in Fall 1990, the Planning Secretariat at Alberta Agriculture became an information resource for individuals and groups who wished to express opinions or ask questions about the proposal. Since then, the Planning Secretariat has received over 300 calls on its Freedom to Choose hotline and has responded to over 60 invitations from producer groups and industry organizations to discuss the proposal. The Associate Minister and I have also attended numerous local and interprovincial meetings to discuss the proposal and have responded to many letters on the subject.

I extend appreciation to those who have pursued the clarification they required to make a well informed decision on the Freedom to Choose proposal. I also thank those who have offered suggestions on how the original proposal could be amended. Every effort has been made to respond to these suggestions, guided by the principles and objectives under which the proposal was originally developed.

With release of this addendum, I hope stakeholders will be encouraged to continue to participate in seeking a Prairie-wide solution to the method of payment issue.

Yours truly,

Ernie Isley

Ernie Isley
Minister

c.c. Honourable Shirley McClellan
Associate Minister of Agriculture

# FREEDOM TO CHOOSE:
# ADDENDUM

March 1991

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# INTRODUCTION

The purpose of this addendum is to set out amendments to and clarifications of Alberta's Freedom to Choose proposal. Readers are advised to read the addendum in conjunction with Freedom to Choose. They are also referred to the glossary in this document for explanations of transportation terminology used in both the proposal and the addendum.

A toll free Freedom to Choose hotline **(1-800-661-0056)** is open at the Planning Secretariat in Edmonton from 8:15 a.m. - 4:30 p.m., Monday to Friday. The hotline will be in operation until April 30, 1991. Hotline contacts at the Secretariat are: Ken Beswick (Secretariat Chairman), Gordon Herrington (Secretariat Member), and Frank Kehoe (Secretariat Member). Readers are invited to phone these contacts with their comments and questions as well as with requests for additional copies of the Freedom to Choose proposal and/or this addendum.

# CROW BENEFIT BUY OUT

During the consultative process, concerns and suggestions about the bond buy out were brought forward. In this section of the addendum, these points are addressed through provision of details not included in the Freedom to Choose proposal and/or through presentation of amendments to certain aspects of the proposal.

## Reasons for Basing the Bond on Inherent Productivity

During the Freedom to Choose consultations, questions regarding the basis of attaching the bond to inherent productivity were raised. The reasons center on a number of considerations.

First, the current method of paying the Crow Benefit to the railways distorts the production and marketing of grains and other crops, and it is a subsidy paid on the transportation of export grains. Freedom to Choose sought to correct these faults in the current method of payment by proposing replacement of payment to the railways with implementation of the bond and cash stream. This replacement would result in removal of distortion from domestic grain prices and removal of the Crow Benefit subsidy from the farm gate price of export grains.

Subsidies paid on the transportation of export grains are not acceptable under current and potential trade agreements. For example, the Canada-United States Free Trade Agreement specifically excludes payment of the Crow Benefit subsidy on the export of eligible grain products to the U. S., except on exports through Thunder Bay. As well, in the event of a multilateral agreement on agricultural subsidies in the current round of GATT negotiations, indications are that the current Crow Benefit payment would be at risk of reduction and possible elimination.

In designing the bond buy out, the trade-related criteria used (which were essentially the same as those in the current GATT negotiations on agricultural subsidies) required that the payment not be linked in any fashion to actual production, marketing or exports. In other words, the payment had to be decoupled. Other considerations, such as expected declines in land values and retention of linkage to the crop sector in the CWB designated area, were equally important in developing the buy out concept.

The bond buy out does not account for production or marketings resulting from individual producers' superior management practices and skills. Nor does it take into account increases (or decreases) in yield due to the weather factors influencing production in any one year. Any linkage of the bond and cash stream to factors such as actual production and marketings could result in the buy out being subject to the same risks GATT has already associated with the current method of paying the railways.

Accordingly, the concept of assigning the bond and cash stream on the basis of inherent productivity of arable land in agricultural use was utilized. Inherent productivity is not to be confused with actual production. A subsidy linked to actual production would be considered coupled, and, therefore, could not be considered under the trade-related criteria used.

Inherent productivity is also the foundation of municipal tax assessments of agricultural land. Typical yield, crop rotations, input levels, and soil types form the basis of inherent productivity/net productivity ratings and productivity adjustment factors. The municipal assessment system was utilized in formulating the bond entitlement system.

## Reasons for Assigning the Bond to Landowners

During the consultations, queries arose as to why the bond would be assigned to landowners rather than to the arable land itself or to producers in general (i.e., not all producers own the land they farm).

The first consideration was the trade-related implication of linking actual production and/or marketings and exports to the bond and/or the cash stream. A neutral approach (i.e., using the inherent productivity of arable land rather than actual production, and assignment to the owner as opposed to the land itself) was deemed the most appropriate way of avoiding the risks associated with a GATT agreement to reduce or eliminate trade-related subsidy payments.

The second consideration was the marketability of the assigned bonds. The intent of the Freedom to Choose proposal was to provide bonds free of assignments or conditions that would constrain their use and, consequently, negatively affect their value within the 15-year buy out period. Bonds assigned on the basis of arable acres and inherent productivity of the land, but not directly tied to the land, had the fewest constraints.

Prior to redemption, the value of any type of secure bond is a reflection of the market's perception of its value relative to other investment instruments (i.e., other bonds, stocks, real estate, etc.). Bond conditions and liquidity affect their value. Conditions such as tying the bond to a legal land description and linking that description to either the number of arable acres or the amount of production or marketings from that land would negatively affect the bond's marketability, value and liquidity prior to redemption at the end of the 15-year period. For example, land values (asset and equity) would adjust immediately upon elimination of Crow Benefit subsidy payments to the railways and introduction of the bond. Bonds with conditions tied to them would not necessarily reflect this change until the land and the assigned bond were sold as a parcel within the 15-year period.

## Adjustment Arrangements Between Landowners and Tenants

A frequent concern that arose during the consultations had to do with the concept that producers who were not owners of arable land (i.e., renters) would not receive or have direct claim on the bond and resulting cash stream. In other words, when the producer is not the landowner and a lease exists (i.e., crop-share,

stream and, unless accommodated, the renter-producer would be faced with the full costs of transporting export grains.

In developing the Freedom to Choose proposal, it was recognized that individual farmers cannot adjust to increases in transportation costs by increasing market prices or decreasing the costs of their inputs. Therefore, it was intended that adjustment would be financed from the cash stream provided by the bond.

Today's rents incorporate capitalization of the WGTA into land values and access to subsidy payments by way of production and market access. Rent levels are also a function of other factors, such as commodity prices, soil, climate, distance to market and urban proximity, so rent levels vary considerably and each factor contributing to a rental agreement is not easily identified or common to all rental agreements. Rent costs and risk sharing vary widely among individual agreements. For these reasons the proposal could not include details regarding the extent to which leases or rents should be adjusted. However, the intent of the bond cash stream is to allow for adjustment to paying the full costs of transportation. It is therefore intended that the necessary adjustment would be undertaken and agreed to by the landowner and the tenant with due regard to the terms and conditions of their existing contractual arrangements.

Where agreement could not be reached, it is proposed that an appropriate appeal/review mechanism be provided to allow agreement between a landowner and an existing tenant prior to or immediately after implementation of Freedom to Choose. This mechanism would deal solely with disputes over rental arrangements arising from implementation of the buy out.

The mechanism could be either binding or non-binding. Both types are commonly used in agriculture. An example of a binding appeal mechanism for resolving a dispute is the Surface Rights Appeal Board, whose verdict on the dispute is binding on the parties involved in the appeal and hearings. An example of a non-binding appeal mechanism is the process being used by the Farm Debt Review Board. The Board's mechanism provides for a hearing and presentation of subsequent findings and recommendations, but these findings and recommendations do not have to be adhered to by the parties involved.

Neither a binding nor non-binding mechanism have been recommended in the proposal. Both mechanisms have advantages and disadvantages, and a clear preference for one above the other is not evident. Perhaps both mechanisms would be appropriate, but it is suggested that more discussion within the farming community could be beneficial before a decision were made.

## Designation of Bond Entitlement

It was originally proposed that beneficiaries of the bond would be the owners of freehold arable land within the CWB designated area. The Crow Benefit was deemed to be a benefit for the grain producers in the CWB designated area. This consideration highlighted the need to retain this benefit within the grain sector and within the geographic region currently in receipt of the subsidy. For these reasons, non-arable land and non-grain/non-crop commodities, such as cattle and hogs, were excluded from direct entitlement.

It is now proposed that entitlement be expanded to include:

— Those persons who have rights of eventual ownership of arable acres owned by the Crown by way of contractual agreements (i.e., arable land actually opened under homesteading agreements and farm development lease agreements);

— Those Indian bands and Metis settlements assigned or dedicated arable Crown acres for agricultural use through Acts of Parliament and Legislatures; and

— Those arable acres owned by municipalities and those arable acres administered by local authorities in the right of the Crown for municipalities. (In Alberta's case, this would include the arable acres in the Special Areas and Improvement Districts.)

Producers currently utilizing these acres have access to the Federal Government share of the Crow Benefit and so should have access, where applicable, to the bond and cash stream. The inclusion of these acres would, in the case of Alberta, involve estimated maximums of 220,000 acres under homesteading and farm development agreements; 560,000 acres assigned to Indian bands; 500,000 acres dedicated under Metis settlement agreements; and 200,000 acres in cultivation leases for land owned or administered by municipalities and local authorities.

The addition of these entitlements will result in a change to the Freedom to Choose proposal estimate of the mean entitlement per acre. The original mean entitlement was $86 per acre. This estimate was based on the bond value of $7.2 billion, 81.206 million dryland acres, and 1.38 million irrigated acres x 1.48. The calculation will now include the estimated entitlements under homesteading and farm development agreements (220,000 acres) and those assigned to Indian bands and Metis settlements (560,000 + 500,000 acres), but not the 200,000 acres in cultivation leases (since these entitlements have already been incorporated into the original estimate of 81.206 million dryland acres). Similar entitlements will have to be added for Saskatchewan and Manitoba. These additions should not alter the mean entitlement by more than $2.00 per acre.

Arable land owned and administered by the Crown itself would not be eligible for a bond entitlement. However, it is proposed that rental rates on this land would be adjusted to reflect renting grain producers being responsible for paying the full cost of grain transportation.

It is also proposed that a review/appeal process be provided to deal with questions related to establishment of entitlement and assessment of arable acres, productivity, and distance adjustment factors. Appeals would be subject to some conditions to avoid frivolous applications. The mechanism for reviewing these appeals would be a body separate from the mechanism that would be provided for landowner/renter adjustment agreements.

## Use of the Municipal Tax Assessment System in Determining Net Productivity Ratings

A number of land/soil classification systems are in use in Canada. Two of these systems are the municipal tax assessment system and the Canada Land Inventory (CLI) system for agricultural soil capability.

While the CLI is an appropriate tool for broad scale planning, it was not utilized in the Freedom to Choose proposal. Rather, the proposal recommends and is based on the municipal tax assessment rating system. This system was chosen because it allows for site-specific assessment of individual acres. While the CLI accommodates the existence of cultivation practices within its numerical (1 - 6) classifications, municipal assessment identifies each and every acre that is arable and suitable for cultivation. To this extent, the municipal system captures the lower capability CLI classifications (i.e., 4 - 6) that are being cropped. Therefore, CLI 4 - 6 lands would not necessarily be disqualified from bond entitlement.

Net, long term income is the premise upon which the municipal tax assessment rating system for farm land is built. In order to make

valid comparisons of net, long term income, a standard set of components has been utilized in establishing the rating system. In Alberta, eleven years of indexed commodity prices were averaged to obtain a standard to 1982, the cost year chosen for the 1984 tax assessment manual. These average prices were indexed and averaged to the same level. The same procedure was utilized for all types of agricultural property, namely dryland arable, irrigation and pasture. The data provide standards with which to compare incomes in various areas to the income of a top ranked area.

In the municipal system, **dryland arable** is defined as land assumed to derive an income stream mainly from four basic crops—wheat, barley, canola and hay. The soil group type is used as the basis for the rating; with adjustments for conditions deemed to be detrimental to the income stream. **Irrigation arable** is defined as land assumed to derive an income stream from the four basic crops plus a wide range of economic crop options not usually grown on dryland. The soil series is the basis used for the irrigation rating. **Pasture land** is assumed to derive an income stream from the livestock which utilize the forage produced. Beef is the commodity and carrying capacity is the standard measure that the rating is based upon.

The same type of system is used throughout the CWB designated area. The system and the assessment are applied on a provincial basis.

The soil type in the dryland climatic region showing the highest net income was determined to have a numeric rating of 100. All soil types in each climatic region are ranked in comparison to this established point. Soils having inferior physical characteristics or located in less favourable climatic areas are ranked at a lower rating based on their economic performance in comparison to the best. In Alberta, the black soil zone in the southern portion of agricultural climate area #1 (Olds) was found to produce the highest income under dryland farming practices.

The highest rating under irrigation was determined by utilizing the crop weighting as determined by the Irrigation District "ditch riders" records. Five to seven years of records were analyzed to determine the weighting. The costs were extrapolated from consensus research data by Alberta Agriculture. The input level represents the most likely input costs to obtain the yield expected by the average farm operator.

The Chin soil series in the Vauxhall area of the Bow River Irrigation District showed the highest net income potential. The soils that are located in areas that are less favourable or that have physical characteristics shown to be less desirable via the crop weighting and expected yields are ranked at a lower rating.

In the Freedom to Choose proposal, the weighted mean productivity rating in the CWB designated area was estimated at 0.75. This means that all arable land in this area has, on average, 75 percent of the average net productivity of the best land. In practice, the aggregate of all assessments, weighted by acres, would provide a precise measure of the weighted mean productivity rating for the whole of the CWB designated area. This would then provide for the exact calculation of the mean entitlement per acre.

## Bond Entitlement for Irrigated Land

In the case of irrigated land, the Freedom to Choose proposal provided for the application of a factor of 1.48 to arable acres in conjunction with a productivity adjustment factor for dryland arable farm land. Use of the dryland arable productivity adjustment factor for irrigated acres was incorrect. More correctly, use of municipal tax assessments provides separate productivity ratings for dryland arable land and irrigated arable land.

It is proposed that these two assessment ratings be used to establish entitlements. In order to arrive at comparable productivity ratings between dryland and irrigated land, an irrigated acre's net productivity rating needs to be multiplied by 1.48 to reflect the inherent difference in revenues derived from dryland and irrigated land.

These requirements amend the formula to establish the mean entitlement per acre as well as the formula for the individual entitlement.

The formula for the mean entitlement per acre should be:

$$\frac{NPV}{(A \times PAF_D) + (I \times PAF_I) \times DAF} = E$$

where:

- NPV = Bond value of $7.2 billion.
- A = Sum of all dryland arable acres (approximately 82.6 million acres).
- I = Sum of all irrigated acres (approximately 1.4 million acres).
- $PAF_D$ = Dryland average productivity adjustment factor of 1.
- $PAF_I$ = Irrigation average productivity adjustment factor of 1 x 1.48.
- DAF = Average distance adjustment factor of 1.
- E = Mean entitlement per acre.

The formula for an individual entitlement would be the sum of dryland and irrigated entitlements:

$AA \times PAF_D \times DAF \times E = AE_D$ (Dryland)

$II \times PAF_I \times DAF \times E = AE_I$ (Irrigated)

and

$AE_D + AE_I = AE$ (Sum of dryland and irrigated)

where:

- AA = Sum of the landowner's dryland arable acres.
- II = Sum of the landowner's irrigated acres.
- $PAF_D$ = Dryland productivity factor.
- $PAF_I$ = Irrigated productivity factor.
- DAF = Distance adjustment factor.
- E = Mean entitlement per acre.
- $AE_D$ = Individual entitlement for dryland acres.
- $AE_I$ = Individual entitlement for irrigated acres.
- AE = Sum of both entitlements.

The main difference between the formula proposed in Freedom to Choose and the above formula lies in the calculation of $PAF_I$ (irrigated productivity factor). In the proposal, the assessment rating applied to irrigated land reflected its inherent productivity as being that of dryland use.

For example, using the dryland rating of inherent productivity, the Chin soil series in the Vauxhall, Alberta area would have been rated at 0.60 in comparison to the best rated dryland (which is given a rating of 1.0); that is, the Chin series would have had a productivity factor of:

$$\frac{.60 \times 1.48}{.75^*} = 1.18.$$

However, under a rating relative to the best-rated irrigated land, this same land would have a net productivity rating of 1.0 (i.e., it is the best-rated irrigated land in Alberta). Therefore, its productivity factor should be calculated as being:

$$\frac{1.0 \times 1.48}{.75^*} = 1.97.$$

Utilizing the correct productivity rating for irrigated land alters the calculation of the net productivity rating. Instead of having a net productivity rating of 1.18, the land in the Chin soil series now has been designated a rating of 1.97.

The change in the formula would result in changes to the calculation of the net productivity of all irrigated land, those changes being of the same extent as illustrated in the above Chin soil series example.

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.75* = The estimated weighted mean productivity rating in the CWB designated area of all arable land relative to the best-rated dryland and irrigated land.

## Definition of Dilution

During the consultative process, questions about dilution continued to be expressed. There is no universal understanding or definition of dilution even though it has been a long standing issue in the method of payment debate. However, two possible definitions of dilution can be derived from previous reviews of the Crow Benefit method of payment, one review being led by Clay Gilson and the other by Justice Gordon C. Hall.

In one definition, dilution can be understood to be the reduction in the per unit payment of the Federal Government share of the statutory freight rate if payment were not confined to eligible export grains (for example, if the fixed amount of the Crow Benefit were applied not only to the transportation of 30 million tonnes of grain sales for export, but also to the sale of 10 million tonnes in the domestic market).

The second definition can be based on the concept of loss of income by the grain farmer arising from a change in the method of paying the Crow Benefit subsidy. An example of loss of income is the decline in the price of grain sold in the domestic market that would result from removal of the current price distortion.

Neither Gilson nor Hall clearly specified or defined what was meant by reduction in or loss of income, but they did identify two sources of potential change in grain farmers' income. The first source was dilution caused by spreading the Federal Government share of the Crow Benefit over more than export grains. The second source was dilution caused by changes in the price of domestically sold grains. These price changes were perceived to vary between commodities, regions, and even between producers. For example, distortion in the price of domestically sold barley varies between localities. Furthermore, the distortion in the domestic price of feed wheat is probably less than the distortion in the price of barley in the same locality.

The basis for measurement to be used in any changed method of paying the Crow Benefit—e.g., historical or current, acres, production, disposition, ownership or use—also determines the relevance of dilution. In all proposals considered by Gilson and Hall, net dilution was deemed to exist and a variety of compensatory devices were created to deal with the perceived losses and to facilitate adjustment within a limited timeframe (for example, the Agriculture Adjustment Fund suggested by Gilson). The apparent assumption was that losses were expected to exceed the value of Crow subsidy payments to farmers and that any new method of paying the subsidy would create losses for some producers and gains for others.

In the thorough quantitative impact analyses conducted for both the 1989 Alberta, British Columbia Government/Alberta Wheat Pool proposal and the 1990 Freedom to Choose proposal, it was found that paying the producer the Crow Benefit could result in gross revenue gains to the grain sector. In both proposals, dilution was broadly defined as income loss; that is, loss in gross revenue net of transportation costs arising from a change to the WGTA and the method of paying the Crow Benefit. This definition encompasses the narrower definition of loss arising from spreading the subsidy over more than export grains and broadens it to one which could be applied to any proposal on changing the WGTA and/or the method of payment.

The Freedom to Choose proposal measured dilution both on a regional basis and, to the extent possible, on an individual farm basis. Regionally, dilution was not found to exist; individually, the risks of significant dilution were minimal and confined to the situation of above-average production of a single export crop with no potential for production and marketing alternatives. Table 1 provides a sample of potential net benefits or net dilution at the individual farm level under a Crow Benefit buy out.

## Livestock Production Increases and Market Opportunities

By removing the distortion existing in domestic grain prices, implementation of the Freedom to Choose proposal would provide economic incentives for increased production of beef cattle and hogs. For example, the impact study conducted for the proposal indicates that the breeding herd inventory could expand by 280,000 head in Western Canada. As well, cattle feeding could expand by 450,000 head per annum. This feeding increase would arise from a combination of expansion in output from the breeding herd, increased retention of feeder cattle which would have been exported, and importation of feeders from outside the CWB designated area. Annual hog production was estimated to increase by 297,000 hogs (18,000 sows).

In the case of beef cattle, the expected increase in slaughter ready cattle represents 0.7 percent of total North American output. North America is a net importer of both beef and pork and it would remain a net importer even if the increases in output arising from the implementation of the proposal were entirely directed into that market.

These increases in output need not be consigned into only the Canadian or U.S. markets. Pacific Rim and eastern European demand for red meats is rising, and certain markets in these regions provide opportunities for export activity out of Western Canada, particularly for beef. With the reduction in feed prices that would result from implementation of the proposal, these markets could be competitively accessed by the Western Canadian red meat industry.

# TABLE 1

FIFTEEN YEAR CUMULATIVE INCOME EFFECTS UNDER A CROW BENEFIT BUY OUT COMPARED TO THE STATUS QUO ON REPRESENTATIVE ALBERTA FARMS

| REGION IN ALBERTA/ TYPE OF FARM | ARABLE ACRES | PROPORTION OF GRAINS EXPORTED | GAIN (LOSS) COMPARED TO STATUS QUO |
|---|---|---|---|
| **South** | | | |
| Wheat Fallow Farm | 1250 | 100% | $108,763 |
| Mixed Grains Farm | 2040 | 100% | $171,442 |
| Hay-Pasture Farm Bringing in Feed & Feeders* | 1000 | 0% | $397,460 |
| **West Central** | | | |
| Mixed Grains Farm | 1250 | 33% | $145,481 |
| Farrow-Finish Farm, Buying All Feed | 0 | 0% | $117,000 |
| Mixed Grains Farm* | 1000 | 50% | $ 19,360 |
| **East Central** | | | |
| Mixed Grains Farm | 686 | 62% | $102,729 |
| Cow-Calf Farm Using Homegrown Feed | 640 | 0% | $149,853 |
| **North Central** | | | |
| Mixed Grains Farm | 782 | 83% | $ 71,198 |
| **North** | | | |
| Grain-Forage Seed Farm | 761 | 100% | $ 38,396 |
| Grain-Forage Seed-Hay Farm | 920 | 100% | $ 88,417 |
| Grain Farm* | 1000 | 100% | $ 28,032 |

* Examples taken from details provided in Alberta Wheat Pool, "The Budget," October 5, 1990.

# REVISION OF LEGISLATION AND REGULATIONS

The second component of the Freedom to Choose proposal focussed on a revision of the WGTA rate structure as well as on regulatory changes which would be required both to promote efficiency in the grain handling and transportation system and to provide price signals to transportation users. This section of the addendum addresses changes to and clarifications of the proposal arising from concerns, questions and comments voiced during the consultative process.

## Reasons for Changing the Freight Rate Structure

Since the current method of paying the Crow Benefit to the railways shields farmers from paying the actual costs of transportation, it is generally accepted that it slows the development of a more efficient transportation system. Changing the method of payment and leaving the current rate structure unchanged, however, would not necessarily result in a substantially lower cost grain transportation system. This was the finding of the 1989 Alberta, B.C. Government/Alberta Wheat Pool investigation into the method of payment issue. The results of this study indicated limited change in transportation efficiency under a producer method of payment if the current rate structure were retained.

If farmers are given the Crow Benefit funds directly, they must also be given the opportunity to make choices based on the underlying costs of transportation. If farmers are to influence cost savings in the grain handling and transportation system, they must be presented with a rate structure that reflects (at least to some degree) the underlying costs of that system.

## Reasons for Using a Base Rate Structure

Over the course of the method of payment debate, many have advocated a cost - or market-based rate structure. They believe that these structures could determine the true costs of each grain movement and thereby provide proper signals to producers regarding the costs of moving grain. However, while many argue in favour of a cost - or market-based rate structure, most stop short of determining exactly how such a system would work. This is probably a result of the fact that, while the concept of a market - or cost-oriented system may be desirable, the application of such a system to the Canadian grain industry may not be feasible at the present time.

For instance, under a **market-based system**, all costs for rail transportation would be based on what the market would bear. Under such a system, competition would be required to keep prices at levels that reflected the underlying cost of the operation and/or the costs of other alternatives for moving grain.

In Canada, there are only two national railways, and most elevators have access to only one. Under a free market-based system, there would be nothing in the farmers' favour to balance against the potential monopoly power that the railways could exercise. Trucks, while useful for the movement of grain to inland terminals and to high capacity elevators, could not compete with the railways for long distance moves if both sectors were allowed to price competitively (as in the U.S.). Road capacity limitations, intercity congestion and terminal configuration at both eastern and western ports also preclude the ability of trucks to compete with railways for export movements of grain.

A **cost-based system** would also have problems since it is difficult to determine the actual cost of a specific movement. Furthermore, a cost-based rate structure, since it would have to be strictly applied, would not provide the railways with enough flexibility to compete with trucks for inland movements and would not lead to a lower cost system over the long term.

Currently, we have an average cost system based on total system costs which are averaged for the two railways and between main lines and branch lines, with specific rates based on distance. Under a specific cost system, railway costs would be broken down into their component parts and assigned to specific movements.

Both cost-based applications would have the same difficulties. For instance, the current average cost-based system provides little incentive to a railway that lowers grain transportation costs since the savings are taken away at each recosting and the associated contribution to the railway's constant costs is also reduced. Although in real dollar terms railways have become more efficient in the movement of grain to export ports over the past few years, this has not been the result of any incentives for the grain sector to become more efficient. In fact, most of the improvements in railway grain transportation efficiency in the last few years are the result of systemwide improvements, and have only benefited the grain transportation sector since it is part of the greater rail system. For example, automated train control, cabooseless trains, double tracking, tunnel construction and computer-assisted management have lowered the real costs of rail transportation. The only efficiency-creating initiatives specific to the grain sector are branch line reductions and incentive rates.

The railways appear to have been more receptive to reductions in high-cost branch lines than to other efficiency measures, possibly due to the cost-plus nature of the existing system. However, when grain deliveries are transferred from branch to main lines and lines are abandoned, the system saves only the line-related cost. Movement costs, on the other hand, still reflect small car spots on main lines; hence, efficiency gains are small.

Incentive rates are one attempt to encourage multi-car shipments. However, to date, they have not been very effective in reducing costs. Railways are often not eager to offer incentive rates since they are compensated for the variable costs of grain movement through the WGTA and receive an additional 20 percent of their variable costs as a contribution to constant costs.

In effect, if the railways utilize improved management to better coordinate movement in the grain system, they lose the associated savings from the cost base. In addition, as the cost base declines, their allocation for overhead (contribution to constant costs) declines. In other words, as management costs for better coordination increase, the payment for management services declines. As a result, there is no incentive for a railway to promote or undertake efficient movements in the grain sector. Thus, at the present time, a strict cost-based system, like a market-based one, is not necessarily in the best interest of either farmers or the railways.

The proposal therefore advocates that a rate structure system be employed that utilizes the base rate scale to set a guideline or maximum rate, yet allow the railways to offer incentives to lower the rate in areas where they see fit. In addition, due to the high line-related costs of branch lines (on average about $6.00 per tonne of grain originated on these lines), there should be some surcharge to reflect these extra costs.

## Regulation of the Branch Line Surcharge

The branch line surcharge should be regulated. The surcharge cannot be market-determined since some areas would see their farming viability threatened due to excessive transportation costs. It is suggested that the surcharge be based on the rail distance to the main line in order to cover at least some portion of the extra cost of the branch line as a whole. Since not all the costs would be reflected in the branch line surcharge, there would continue to be an element of cross subsidization in the system. However, farmers on branch lines would begin to receive signals as to the extra costs they were incurring as well as the potential savings that were available by delivering their grain to elevators that facilitated greater system efficiency.

## Railways' Efficiency/Productivity Savings

It is suggested that the railways be allowed to keep some amount of the grain-related rail productivity savings over a longer period than the maximum four-year interval between recostings in order to provide them with the incentive to improve efficiency specifically for the grain sector. In return for this, the railways would have their contribution to constant costs reduced (as advocated by the Canadian Transport Commission in 1984).

## Demurrage and Dispatch

Demurrage is normally charged to shippers who exceed the specified period for loading or unloading cars. These charges are established to encourage faster turn around of rail cars and to ensure appropriate utilization. As a result of an Order-In-Council in the late 1950's, demurrage is not being assessed on the movement of grain. With a revised rate structure, it is envisaged that restrictions on the application of demurrage would be removed.

It has been suggested that in return for reinstating demurrage, some provision should be made to reward shippers when cars are used efficiently. A system of bonus payments, generally referred to as dispatch, may not be required. Instead, better utilization of railway cars would be taken into account through the railway costing system, which would eventually pass savings back to producers. Between costing reviews, a portion of these savings would be passed back to shippers through the use of incentive rates.

## Revision of the Rate Taper

While the Freedom to Choose proposal recommended revisions to the rate taper on distances greater than 1,200 miles, evidence on the issue of whether the rate taper properly reflects line haul costs is inconclusive. Therefore, further investigation of this issue is warranted before considering changes.

## Potential Changes in the CWB Car Allocation System

Additional flexibility is required in the car allocation system in order to allow shippers to take advantage of incentive rail rates and to facilitate competition between rail and truck. Under the current system for Board grains, allocation of rail cars is strictly controlled by the Canadian Wheat Board. Cars are allocated by the Wheat Board at the train run level and the transfer of cars between train runs is restricted. Allocation of rail cars for domestic feed grain and canola is controlled by the Grain Transportation Agency, but is less regulated than the Wheat Board system.

Grain companies require additional flexibility to be able to take advantage of the relaxed incentive rate provisions provided for in the Freedom to Choose proposal and to better manage their system.

The Wheat Board could, for example, provide a system of bidding for the opportunity to move grain forward to sales position. Under such a system, the CWB would indicate its grain requirements, port destination and time period for shipment, and grain companies would respond with the volumes they are prepared to move. Farmers would be guaranteed the CWB initial payment less elevation and transportation costs. The Wheat Board could accept tenders on the basis of lowest transportation and handling cost (highest prices available to farmers).

Provision would have to be made for financial penalties if grain companies were unable to meet their commitments. Grain companies and railways could deal directly for the provision of rail cars for non-Board and off-Board grain while provision of cars for Board grains would be allocated on the basis of the CWB's acceptance of tenders.

## Impact of the Changes

The combination of changes to the rate structure and a move to a more flexible car allocation process would provide both the railways and elevator companies with the ability to undertake lower cost movements. Competition for farmers' grain (in the form of price offered at the elevator) would promote utilization of these opportunities and, in turn, create a more efficient grain transportation system.

# SUMMARY

Western Canadian farmers are world traders; their livelihood depends on their competitive ability to trade their products on both the domestic and international markets. The domestic market is too small to absorb their production. Consequently, their increasing ability to compete in wider markets is of long term importance.

The extensive analysis conducted for the Freedom to Choose proposal confirmed that Western Canadian farmers are very efficient in allocating their resources; that is, they know how to use their factors of production (land, labour, capital and entrepreneurship) in the most optimum manner. But their efficiency is hampered by governments applying support measures and regulations in a manner which distorts their decisions about what to produce and how to market their output. Moreover, our transportation and marketing system has been over-regulated to the point where the costs of the system endanger and nullify the efforts of Western Canadian farmers to compete in important world markets.

The Freedom to Choose proposal is a well integrated, comprehensive proposal which addresses the distortions and inefficiencies arising from the application of subsidies through the WGTA. Moreover, it is based on sound principles and criteria with specific and well defined objectives. It does not and cannot cure all the ills and misfortunes confronting Western Canadian farmers, but it is an integral and essential part of the efforts being made to solve the problems plaguing agriculture today.

The basic premise of the proposal rests on the principles of the need for increased market responsiveness and self-reliance with due recognition of regional diversity. These principles form the basis of all National Agricultural Policy Review efforts to provide the necessary framework within which the agricultural industry can operate efficiently and effectively. The proposal also strictly adheres to a number of criteria deemed essential for the competitive survival of Western Canadian farmers in the global marketplace. For example, the proposal meets criteria and Federal Government Trade Agreement proposals deemed appropriate for trade under a comprehensive GATT agreement on agriculture trade and agricultural subsidies. The proposal also addresses the need, even in a domestic market context, to remove distortions, reduce costs and allow benefits to accrue to those who are prepared to diversify or seek efficiencies in their operations.

Most important, the proposal is designed to remove government from "the back pocket" of the farmer, grain handler and transporter and to allow these players to make decisions and choices which are in their own best interest. This does not mean government would withdraw all support, but it does mean that government would cease to influence decisions which rightly should be made by the individual. The proposal confines government activities to provision of support, policy, legislation and regulations which are neutral in their effects on participants in the grain and livestock industries of Western Canada.

Clearly, the existing regime is inappropriate for meeting today's requirements and those of the foreseeable future. The system is faulted in many ways, and has demonstrated a high degree of inflexibility and inability to adapt and change. The Freedom to Choose proposal is a viable alternative since it is both technically feasible and based on sound economic principles. Moreover, it provides for flexibility in a regulatory environment.

The Government of Alberta believes that the proposal merits serious and thoughtful consideration by all stakeholders.

# APPENDIX A: GLOSSARY

## Constant Costs:

The difference between the variable costs of all rail traffic and total costs. Total costs are the sum of the operating and depreciation expenses in the railways' accounts and the cost of capital applied to the asset base. Variable costs are the sum of the line-related and volume-related costs.

## Contribution of Constant Costs:

By definition, constant costs, while they exist at least in part, cannot be assigned to any one commodity by cost allocation. However, since they exist, they must be paid by some commodities. This dilemma is resolved by sharing the contribution to constant costs. The level of contribution is set in legislation on an arbitrary basis.

## Demurrage:

An extra charge applied to a car loader, car unloader, or grain owner undertaking more than the specified time to unload or load a rail car or an extra charge applied to someone using a rail car for storage.

## Dispatch:

A bonus or premium paid to a rail car loader or unloader for returning the rail car to the railway faster than required.

## Eligible Costs (Cost Base):

Each year the National Transportation Agency updates base year costs by applying a price index and other adjustments. The result of this calculation is the eligible costs for that crop year. Rates are designed so that they bring in revenue equal to estimated eligible costs.

## Line-Related Variable Costs:

Part of the cost associated with lines on which the traffic originated or terminated is dedicated to one commodity, i.e., grain. It includes the full cost of capital and depreciation of the line as well as property taxes and maintenance of the line. Things like crew costs on the line are not included in line costs. While line-related costs do not change with more or less volume of traffic on the line, they are said to be variable since they would disappear if all grain traffic disappeared.

## Non-Board Grains:

Grains other than wheat or barley which are not marketed by the Canadian Wheat Board (i.e., rye, oats, flax, canola).

## Off-Board Grains:

Domestic wheat or barley that is marketed in Western Canada but not sold to (or purchased from) the Canadian Wheat Board.

## Quadrennial Cost Review (Recosting):

Every four years, during the National Transportation Agency's quadrennial review, the railways' base year costs for moving traffic are calculated in detail. Base year costs include the volume- and line-related costs for a base year as well as a contribution to fixed costs and any adjustments the Agency wishes to make. The freight rate for grain is largely dependent on the base year costs.

## Rate Taper:

The amount a rate changes with a change in distance is known as the rate taper. The WGTA rate has one taper for below 1,200 miles and another taper for above 1,200 miles.

## Volume-Related Variable Costs:

Railway costs that go up or down with volume shipped. Depending on the activity being costed, this volume may be measured in tonnes, carloads, train miles, etc.